JOINT ECONOMIC COMMITTEE REPUBLICAN SENATE STAFF

Recent Economic Developments

Vol. 1, No. 2 Senator Robert F. Bennett July 30, 2002

CAUTIOUS OPTIMISM, DESPITE STOCK MARKET DECLINES

The Bear Market Need Not Imply a Return to Recession

Recent economic data are encouraging and point to moderate growth. Recent stock market declines raise some concerns, but economic indicators and history suggest that the declines aren't sufficient to return the economy to recession (see page two, "Bear Markets and the Economy").

Reasons for Caution: Falling stock prices, sluggish labor markets, and a fall in durables

- **Stock Markets** have fallen substantially, especially in recent weeks.
- **Employment** growth has been slow, but positive, in recent months. The **Unemployment Rate** edged up to 5.9 percent in June, from 5.8 percent in May. A slow recovery in labor markets is not surprising for this stage of the business cycle.
- Orders for **Durable Goods**, an indicator of business investment and demand for long-lived consumer products, fell almost 4 percent in June, reversing recent gains.

Reasons for Optimism: Moderate growth, low inflation

- **Industrial Production** has grown for six straight months, with a large gain in June. **Capacity Utilization**, while low, continues to grow.
- **Corporate Profits** have shown signs of improvement.
- **Retail Sales** posted a solid gain in June, offsetting the decline in May.
- **Housing Starts** and the overall housing market remain strong.
- **Inflation** in consumer and producer prices continues to be subdued.
- **Business Inventories** remain very low, pointing to future inventory rebuilding.

Other Notable Developments: The Fed, the Dollar, Trade, and Forecasts

- Financial markets predict little or no change in the **Fed's** interest rate policy.
- The **Dollar** has fallen significantly, especially over the past three months; the decline makes U.S. exports more competitive overseas, but increases the cost of imports.
- The **Trade Deficit** widened again in May. Imports grew faster than exports, reflecting the continued strength of U.S. demand relative to our trading partners.
- After unusually strong GDP growth (6.1%) in the first quarter, the administration, Federal Reserve, and private **Forecasts** see more moderate growth of 2.0 to 2.5% in the second quarter, rising to 3.0 to 3.5% by year-end. These rates imply that 2002 growth will be about 2.7% on a year-over-year basis, or 3.6% on a Q4-over-Q4 basis.

Note: Second quarter **GDP** will be announced on July 31, along with GDP revisions for the past three years. Initial indications suggest that some of these revisions may be significant.

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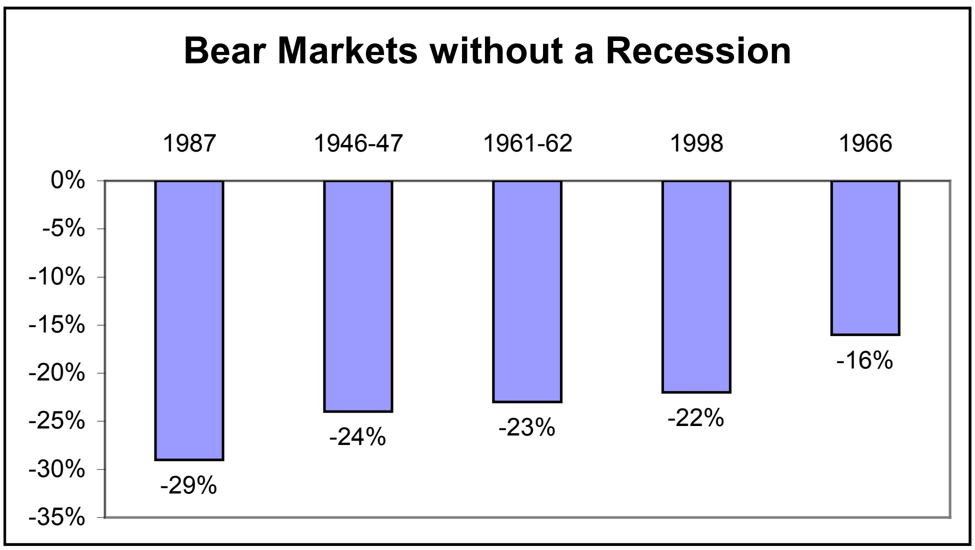
BEAR MARKETS AND THE ECONOMY

The stock market has predicted nine out of the last five recessions. (Paul Samuelson, 1966)

Stock market declines do not always lead to recessions; "false alarms" are common.

Bear Market Facts

- We are in a bear market. The S&P 500 has fallen as much as 30% from its recent high in March and 45% from its 2000 peak.
- Bear markets are common. There have been 15 bear markets since 1929.
- Some bear markets have been *caused by* economic slowdowns – the declines in 1973-74, 1981-82, and 2000-2001 are leading examples. Other stock market declines have occurred without any recession – recent examples are the declines in 1987 and 1998.
- In the post-war period there have been five occasions when stocks declined 15% or more *without any recession* in the subsequent 12 months. These are:



How the Bear Market May Affect the Economy

- Today, the worry is that the recent stock market decline might trigger another recession by dampening consumer spending. However, the link between the stock market and consumer spending is not that strong. One mitigating factor today is that most households have more wealth in their home than in the stock market, and housing prices continue to grow steadily.
- The stock market decline reflects an increase in the cost of capital; investors now demand a higher premium on riskier investments like stocks or corporate debt.
- The higher cost of capital might make it more difficult for firms to increase future investment, but by itself need not trigger a recession.